OPINIONS BELOW.

The opinion of the Court of Appeals for the Seventh Circuit for which this writ is sought, is not yet reported. A copy of said opinion is attached hereto, as Appendix I. There was no written opinion of the district court other than the statement of reasons that the ruling contained in the Order Overruling the Motion for Summary Judgment from which the appeal was taken. A copy of said order, entered June 28, 1967, and a copy of the order of amendment thereof, to include the statement prescribed by 28 U. S. C. §1292(b), entered June 24, 1968, are attached hereto as Appendix II. A copy of the order of the Court of Appeals granting leave to appeal under 28 U. S. C. §1292(b) is attached hereto as Appendix III.

JURISDICTION.

The judgment of the Court of Appeals for the Seventh Circuit was dated and entered April 17, 1969.

The statutory provisions believed to confer on this Court jurisdiction to review the judgment in question by writ of certiorari are 28 U. S. C. §§ 1254(1) and 2101(c).

QUESTIONS PRESENTED FOR REVIEW.

1. Whether under the provisions of the Bankruptcy Act, rights of action of former customers of a bankrupt securities dealer, arising out of the alleged conversion of their funds by said dealer, and its alleged use of said funds to purchase securities for its own account, may be asserted by the trustee in bankruptcy of the converting dealer as the basis for an action to recover losses of the bankrupt resulting solely because of market declines in the value

of the purchased securities, against a member firm of the New York Stock Exchange that executed the orders of said dealer in purchasing and selling such securities on said Exchange, with alleged actual or chargeable knowledge of the source of the funds used in payment of such purchases.

2. Whether federal civil liability arises under the Securities Exchange Act of 1934 by reason of alleged violation by a New York Stock Exchange member firm of Rule 405 of the New York Stock Exchange, which provides in pertinent part that every member organization of the Exchange is required, through a general partner or officer holding voting stock to:

(a) Use due diligence to learn the essential facts relative to every customer, every order, and every cash and margin account accepted by such organization; and

(b) Supervise diligently all accounts handled by registered representatives of the organization.

STATUTES, RULES AND REGULATIONS INVOLVED.

The text of the following statutes, rules and regulations involved in this case, is set forth in Appendix IV of this petition:

11 U. S. C. § 96(e)(2) and 5.

11 U. S. C. § 110(a).

11 U. S. C. § 110(c).

11 U. S. C. § 110(e)(1) and (2).

Sections 70(a) and 70(e), July 1, 1898, c. 541, 30 Stat. 565 (U. S. Comp. St. § 9654).

15 U. S. C. § 77(q)(a).

15 U. S. C. § 78f (a) to (d).

15 U. S. C. § 78j.

15 U. S. C. § 78s (b).

15 U. S. C. § 78aa.

Rule 10b(5) of the Securities & Exchange Commission (C. F. A. § 240.10b-5).

Rule 405 of the New York Stock Exchange (2 CCH, N. Y. S. E. Guide ¶ 2405).

STATEMENT OF THE CASE INCLUDING BASIS FOR FEDERAL JURISDICTION.

Petitioner was granted leave to appeal from an interlocutory order containing the statement prescribed by 28 U. S. C. § 1292(b), overruling its motion for summary judgment (R. 44, Cert. App. 38)[1] with respect to Counts I, II and III of the respondent's complaint. (R. 7 to 27, Cert. App. 9 to 24.) In each of said counts respondent, as trustee in bankruptcy of Dobich Securities Corporation, sought to recover damages on account of losses suffered by the bankrupt in the purchase and sale of securities on the New York Stock Exchange. Petitioner, a member firm of the Exchange, purchased and sold such securities at the directions of, and for the account of, the bankrupt, and was alleged to have violated provisions of the federal securities laws which proximately caused the losses. Jurisdiction of the district court as to Count I was alleged to be based on Section 27 of the Securities Exchange Act of 1934 (15 U. S. C. § 78aa), and as to Counts II and III was alleged to be based on 15 U. S. C. §§ 78aa and 77v. Jurisdiction as to each count was also alleged to be based upon diversity of citizenship pursuant to 28 U. S. C. §1332. (R. 9, 16, 19, Cert. App. 9, 16, 18.)

1. In addition to the certified transcript of the entire record filed by petitioner, it has also filed a certified copy of its appendix in the Court of Appeals including the proceedings in that Court. Record references are shown as to both.

The basic facts alleged in Count I (R. 7 to 15, Cert. App. 9 to 15) and incorporated by reference in Counts II and III (R. 16, 19, Cert. App. 16, 18, 19) are as follows:

The bankrupt was engaged in the sale of securities as a dealer licensed in the State of Indiana. Michael Dobich was its president and sole stockholder. Prior to the organization of the corporation, in 1963, Dobich individually had been engaged in the same business under the name of Dobich Securities Company.

At the bankrupt's request, Merrill Lynch opened a cash account in the name of the bankrupt for the purpose of trading in securities, which, also at the bankrupt's request, was thereafter changed to a margin account. (R. 12, 46-48, Cert. App. 12, 38, 40.) All purchases and sales in the accounts were made upon orders issued by the bankrupt and every transaction therein was for its account as principal. All purchases and sales were made at the market price at the time of each transaction. The bankrupt in all instances received the particular securities it ordered purchased for its account, and the full proceeds of all securities which it ordered sold. Merrill Lynch charged and received commissions at the rates established by the New York Stock Exchange on which the purchases and sales were made. (R. 46-51, Cert. App. 39-43.)

Over a period of several months, the bankrupt suffered a net loss from its transactions in the accounts, resulting solely from adverse market fluctuations. There was no claim that Merrill Lynch had any responsibility for the market changes, or that any purchase or sale was made on its recommendation or advice, or that it had anything to do with the decisions of the bankrupt in that respect except to execute its orders. Such losses are alleged to have rendered the bankrupt insolvent. (R. 13, Cert. App. 14.)

The first count is alleged to be brought pursuant to

Section 6 of the Securities Exchange Act of 1934, as amended 15 U. S. C. § 78(f), based on violations of Rule 405 of the New York Stock Exchange which provides, among other things, that every exchange member organization is required, through a general partner or an officer holding voting stock (1) to use due diligence in learning the essential facts relative to every customer, every order, and every cash or margin account accepted or carried by the organization, and (2) to supervise diligently all accounts handled by registered representatives of the organization. The essence of the charge that petitioner violated Rule 405 was that by opening a cash account at the request of the bankrupt, and thereafter permitting a change to a margin account at its request, without taking certain steps to learn the true financial condition of the bankrupt, Merrill Lynch failed to use due diligence in learning the essential facts relative to the customer and the account as required by said rule, and that by allowing the bankrupt to speculate in allegedly highly volatile stocks and engage in an extremely large volume of transactions, including "block trading", "day trades", and "short sales" without taking action to restrict or curb its activities, prior to the time it closed the account, Merrill Lynch failed to use due diligence in supervising the bankrupt's accounts, in violation of said rule. It was further alleged that as a member of the Exchange, Merrill Lynch is subject to its rules and regulations, that said rules have been approved by the Securities & Exchange Commission pursuant to Section 6 of the Securities Exchange Act of 1934 (15 U. S. C. § 78f), and that consequently violation of such rules is a violation of Section 6, actionable under 15 U. S. C. § 78aa.

Count II is based upon alleged violation of Section 17 of the Securities Act of 1933 (15 U. S. C. § 77q), and Section 10 of the Securities Exchange Act of 1934, including Rule 10(b) 5 of the Securities & Exchange Commission,

promulgated thereunder. The acts and omissions alleged in the first count to have constituted failure to use due diligence as required by Rule 405 are alleged in Count II to have constituted a course of business of Merrill Lynch, the natural result of which operated as a fraud or deceit upon the bankrupt in violation of the aforesaid statute and rule, and proximately caused the losses. (R. 16 to 18; Cert. App. 16 to 18.)

Count III charges Merrill Lynch with knowingly aiding and abetting Dobich in the latter's use of a manipulative scheme and device in the sale of stock in violation of the same statute and rule. The means of aiding and abetting charged, are the same acts and omissions alleged in Count I, together with allegations that Merrill Lynch failed to report its alleged knowledge of the bankrupt's operations to the Securities & Exchange Commission or the Indiana Securities Commission, and failed to require the bankrupt to file a report of its financial condition with the Securities & Exchange Commission under Rule 17a-5 of said Commission requiring every broker or dealer subject to the rule to file annual reports of financial condition. Such acts and omissions are alleged in Count III to have constituted a course of business of Merrill Lynch, the natural result of which operated as a fraud or deceit upon the bankrupt in violation of the aforesaid statute and rule, and proximately caused its losses.

Count I further alleged, and the same allegations are incorporated by reference in Counts II and III, that the funds used by the bankrupt to purchase securities and pay commissions, were funds which had been received by the bankrupt from its customers for the purchase of specific securities for them, which the bankrupt had wrongfully converted and used for such purchases for its own account. (R. 11; Cert. App. 12, R. 16; Cert. App. 16, R. 19; Cert. App. 18.) The Court of Appeals affirmed the holding of the

district court that the allegations of use by the bankrupt of converted customers' funds to pay for the securities purchased for its account through petitioner, together with the allegation of actual or chargeable knowledge of petitioner of the source of the funds, constituted such payments fraudulent transfers within the meaning of the fraudulent transfer provisions of the Bankruptcy Act, primarily Section 70(e) (11 U. S. C. § 110(e)), which the trustee was entitled to set aside to the extent of the net loss suffered by the bankrupt. It said:

> "As the district court noted in these three counts plaintiff is asserting creditors' rights to avoid corporate transactions between the bankrupt and defendant. He is seeking to recover net transfers to defendant in fraud of its customers. Defendant counters that only the customers of the bankrupt can file actions of this type. However, the district court concluded that the bankruptcy trustee was the proper party to prosecute the alleged causes of action and that each of these counts adequately states a claim. Therefore, summary judgment was denied to defendant."[2] (Appendix I, p. A 2.)

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2. Note 2 of the opinion of the Court of Appeals states: "Both parties have treated this complaint as having charged the bankrupt with a fraudulent transfer of the customers' funds to defendant. Therefore, we need not consider whether the complaint is also sustainable on the theory that Michael Dobich and defendant defrauded the bankrupt by investing funds entrusted to it and contrary to the authorization of its customers. Any losses thereby incurred by the bankrupt would deplete its estate and might be considered a fraud on its creditors, so that Section 70e would permit the trustee to sue. See *Pettit* v. *American Stock Exchange*, 217 F. Supp. 21, 25, 30-31 (S. D. N. Y. 1963)." The petitioner has at no time treated the complaint as having charged the bankrupt with a fraudulent transfer. In fact fundamental to petitioner's legal argument that any cause of action as alleged belongs to the individual creditor of the bankrupt and not to the trustee is petitioner's firm position that the payments by the bankrupt to petitioner and the securities purchased did *not constitute fraudulent transfers.*

The Court of Appeals further held that federal civil liability under Section 6 of the Securities Exchange Act of 1934 may be predicated upon violation of Rule 405 of the New York Stock Exchange.

ARGUMENT.

I.

REASONS FOR GRANTING THE WRIT WITH RESPECT TO THE FIRST QUESTION.

The decision of the Court of Appeals below has resulted in conflicting interpretations of important provisions of the Bankruptcy Act, which, by constitutional mandate is required to be "uniform . . . throughout the United States." U. S. Const., Art. I, § 8. This conflict has not been, but should be resolved by this Court. The Court of Appeals held that a trustee in bankruptcy is authorized by Section 70(e) (11 U. S. C. § 110e) to maintain an action to set aside as fraudulent transfers, payments of a bankrupt stockbroker to a member of the New York Stock Exchange for securities purchased at market for the bankrupt's account, to the extent of losses resulting solely from declines in market values of such securities, and recover the amount of such losses from said Exchange member, on the ground that such payments were made from funds of the bankrupt's customers which the bankrupt converted and used for such purposes, and that the Exchange member executing the orders of the bankrupt had actual or chargeable notice of the source of such funds. The only prior decision involving said question, which was before this Court only on petition for certiorari, held that no right of action to recover for the fraud and conversion practiced on the customers vested in the trustee in bankruptcy and that no action based on the rights of the customers could be maintained by the trustee. *Barnes* v. *Schatzkin*, 215 App. Div. 10, 212 N. Y. S. 536 (1st Dep't 1925), aff'd per curiam, 242 N. Y. 555, 152 N. E. 424 (1926), cert. den., 273 U. S.

709 (1926). The principles there stated have not been changed by any subsequent amendment of the Bankruptcy Act and are fully applicable to this case.

While a trustee in bankruptcy is vested with all rights of action which the bankrupt possessed (11 U. S. C. § 110(a)), he has no greater rights than the bankrupt would have had, in actions which he can maintain only as the bankrupt's successor. 4A *Collier on Bankruptcy* (14th ed. 1967); pp. 379, 385. In addition, the Bankruptcy Act vests in the trustee certain rights of action as a representative of the bankrupt's creditors, regardless of whether the bankrupt could have maintained such a cause of action. Primarily, at least, these involve actions to set aside fraudulent transfers or follow the proceeds thereof in the hands of persons not having the status of bona fide purchasers. 4A *Collier on Bankruptcy* (14 ed. 1967) p. 149.

Petitioner moved for summary judgment as to Counts I, II and III on the ground that no facts were alleged, or otherwise shown by the record for summary judgment purposes, that could give rise to a corporate cause of action in favor of the bankrupt, and that regardless of the sufficiency of the allegations to state a claim for relief against petitioner in favor of the customer whose funds were converted and used to purchase securities, their rights did not pass to the trustee in bankruptcy under the Bankruptcy Act, and cannot constitute a basis for recovery by the trustee in this action.

The Court of Appeals sustained the holding of the district court that under the facts assumed for summary judgment purposes, the payments to petitioner for securities it had purchased for the account of the bankrupt constituted fraudulent transfers by the bankrupt within the meaning of Section 70 and particularly 70(e) of the Bankruptcy Act (11 U. S. C. § 110e) and that the trustee was authorized

by such provision to maintain an action to recover the amount of the losses suffered by the bankrupt. The Court of Appeals said (Appendix I, pp. A 3 and A 4):

> "The trustee in bankruptcy is attempting to avoid the bankrupt's transfers to defendant on the ground that they were fraudulent or voidable under Federal law as to the bankrupt's creditors * * *.
>
> "The transfers which the trustee is attempting to set aside are the bankrupt's payments to defendant from funds belonging to the bankrupt's customers and which had been unlawfully converted by the bankrupt to purchase securities for its own account."

Despite implications to the contrary in the opinion of the Court of Appeals, petitioner has never challenged in any manner the right of the respondent as trustee in bankruptcy to set aside fraudulent transfers of property of the bankrupt, and recover the proceeds thereof from any recipient other than a bona fide purchaser, without regard to the existence of such cause of action in the bankrupt. What petitioner has contended throughout, which has been answered neither by the District Court or the Court of Appeals, is that the payments to petitioner for the purchases were not fraudulent transfers by the bankrupt within the meaning of the fraudulent transfer provisions of the Bankruptcy Act.

From the very beginning, the entire concept of fraudulent transfers, which creditors have the right to attack, has related to transfers of property owned by the debtor and available for the payment of his debts, made either without receiving fair consideration therefor when the debtor was insolvent, or on the verge of insolvency, or with an actual intent to hinder, delay or defraud creditors. The essence of such a claim has always been depletion of the debtor's assets available for creditors' claims.

This concept has been carried into all of the fraudulent

transfer provisions of the Bankruptcy Act. It is the property *of the bankrupt* fraudulently transferred, to which the trustee has title under § 70(a) (11 U. S. C. § 110a) regardless of any such transfer, and it is "*all property of the debtor* affected by such a transfer" that is to remain a part of his assets and pass to the trustee discharged and released from the transfer under § 70(e) (11 U. S. C. § 110e).

The charge that the payments by the bankrupt to petitioner constituted fraudulent transfers, is based solely on the allegation that the bankrupt used property for his own purposes, which did not belong to him. The right of action of the customer whose property was so converted and used, arose, not as a creditor of the bankrupt, but because the property transferred was the customer's property, and not the property of the bankrupt. Under the uncontroverted facts for summary judgment purposes, no true debtor-creditor relation existed between the customers and the bankrupt, since the existence of a chose in action for conversion does not create a creditor status. *Fore Improvement Corp.* v. *Selig*, 278 F. 2d 143, 145 (2d Cir. 1960). Creditors of the bankrupt had no right to look to any part of the funds received from customers, and wrongfully converted by the bankrupt, for payment of their debts, and the bankrupt had no more right to use such funds to pay its debts, than to use them to purchase securities for its own account. Neither the estate of the bankrupt, nor the amount of any funds lawfully available for the payment of the bankrupt's creditors was decreased by the payments for the purchased securities, since admittedly all the securities purchased were bought at market and consequently the bankrupt received full value. The subsequent impairment of value of the purchased property resulted only because of market declines, and no purpose of the bankrupt to defraud or delay creditors by the payments to petitioner was either alleged or inferrable.

Petitioner insists that there is no authority supporting the contention that such payments constituted fraudulent transfers within the meaning of Section 70(e) or otherwise, or the contention that the trustee is entitled to maintain an action to set aside such payment and recover from petitioner in any amount, where the sole basis claimed for such right is, as stated by the Court of Appeals, that:

> "The transfers which the trustee is attempting to set aside are the bankrupt's payments to defendant from funds belonging to the bankrupt's customers and which had been unlawfully converted by the bankrupt to purchase securities for its own accounts." (Appendix I, p. A 3.)

On the contrary, the principles announced by the Court of Appeals in this case with respect to the right of the trustee to maintain an action under such circumstances, based on the fraud and conversion practiced on the customers, are clearly in conflict with *Barnes* v. *Schatzkin, supra.* In that case the plaintiff, Barnes, was trustee in bankruptcy of Crowley & Co., a securities dealer alleged, as here, to have converted funds of the customers and used such funds in transactions for its own account on the New York Stock Exchange. The defendants, Schatzkin Bernstein & Co., were members of the New York Stock Exchange alleged, as here, to have executed the bankrupt's orders with knowledge of the fraudulent conversions. While the defrauded customers in that case had assigned their claims against the defendants to the trustee, and the trustee was held without legal capacity to maintain an action on the assignments, the basic holding was that under the Bankruptcy Act the rights of the customers did not vest in the trustee. The claim based on the assignments was merely asserted to be an additional ground for sustaining the right of the trustee to maintain the action.

If the rights of the customers vested in the trustee under

the Bankruptcy Act, the attempted assignments were, of course, superfluous. The basic principle announced in the *Barnes* case was that the rights of the individual customers based on the conversion and use of their funds belonged to them and did not pass to the trustee in bankruptcy under the Bankruptcy Act. The court said (212 N. Y. S., pp. 537-539):

> "*The claims on which the plaintiff seeks to recover were never part of the assets of Crowley & Co.,* [the bankrupt] *nor did they arise in favor of the plaintiff as trustee in bankruptcy.*
>
> "*No right of action to recover for the fraud and conversion practiced on these customers was vested in the trustee in bankruptcy. Such right of action was not an asset of the bankrupt estate. In re Beachy & Co.* (D. C.), 170 F. 825; *Seegmiller* v. *Day,* 249 F. 177, 161 C. C. A. 213; *In re Associated Oil Co.* (C. C. A.), 289 F. 693. The claim pleaded arose, if at all, in favor of 164 different customers of Crowley & Co., whose names are set forth in an exhibit attached to the amended complaint. • • •
>
> "A trustee in bankruptcy has only such title and power as given by the Bankruptcy Act. He is a creature of that statute. No serious assertion is made here that these claims, indicated by the complaint, were property of the bankrupt. They were not assets which passed to the trustee because they belonged to the bankrupt. The causes of action which the trustee has by reason of the Bankruptcy Act, other than such as were property of the bankrupt, are causes of action to recover or follow assets. [Emphasis added.]

The only criticism ever made of *Barnes* prior to this case was with respect to the holding (not involved here) denying the trustee's right to sue as the assignee of the customers. See 39 Harv. L. Rev. 768 (1926).

In considering whether the bankruptcy law as it then existed conferred any right on the trustee to maintain an action based on the wrong to the customers, the court

in the *Barnes* case considered both Sections 70(a) and 70(e) of the Bankruptcy Act (30 Stat. 565, c. 541, U. S. Comp. Stats. § 9654), which were partially set out in the opinion. Section 70(a) provided then, as now, that the trustee was vested with the title of the bankrupt in all of the various kinds of property enumerated therein, including all property transferred by him in fraud of creditors, and § 70(e) then provided:

> "The trustee may avoid any transfer by the bankrupt of his property which any creditor of such bankrupt might have avoided, and may recover the property so transferred or its value from the person to whom it was transferred, unless he was a bona fide holder for value prior to the date of the adjudication. Such property may be recovered or its value collected from whomsoever may have received it, except a bona fide holder for value * * *."

While the court in *Barnes*, as the Court of Appeals concedes, specifically recognized the right of the trustee under the Bankruptcy Act to maintain actions as a representative of creditors to set aside fraudulent transfers and follow the proceeds of property fraudulently transferred, it held nevertheless that the bankruptcy law gave him no right to assert the individual claims of customers whose funds had been converted by the bankrupt and used to purchase securities for its own account, regardless of the charge that the defendant stock exchange members had knowledge of, and participated in, such conversion and wrongful use. The unequivocal holding was that:

> "No right of action to recover for the fraud and conversion practices on these customers was vested in the trustee in bankruptcy" (212 N. Y. S. at 537).

The Court of Appeals further states that in its view the *Barnes* case did not face and reject the transfer theory urged here; that it was decided before the enactment of

Sections 70(e) and 60(e) on which respondent relies, and that any lingering doubts about the scope of the trustee's authority under Section 70(e) have been eliminated by the recasting of that provision in 1938, citing 4A *Collier on Bankruptcy* (14th ed. 1967), ¶ 70.69[2].

Obviously, the court in the *Barnes* case did face and reject the theory that the trustee could maintain the action as one to set aside a fraudulent transfer under Section 70(e) as it existed at the time that case was decided. It was there stated that in addition to the right given the trustee by the Bankruptcy Act to sue for anything the bankrupt would have had a right to sue for, the trustee was vested with any cause of action the Bankruptcy Act authorized the trustee to assert, but said that such actions were limited to actions to recover or have an accounting for property of the bankrupt transferred by way of preferences or in fraud of creditors and the like and did not include the right to maintain any action based upon the fraud and conversion practiced on the customers. This is clearly tantamount to a holding that the payments by the bankrupt to the defendants to purchase securities from the converted funds of the customers, did not constitute fraudulent transfers of the bankrupt's property within the meaning of § 70(e) as it existed at that time. This interpretation is confirmed by the following statement in 4A *Collier on Bankruptcy* (14th ed. 1967), p. 149, to which no reference is made by the Court of Appeals:

> "Rights of action belonging to the bankrupt generally pass to his trustee in bankruptcy if subject to levy and sale at the instance of his creditors. This is the plain result of § 70(a)(5). A right of action may, however, be one that can be asserted by creditors of the bankrupt but does not constitute his property in any ordinary sense. An illustration is the right to avoid a fraudulent transfer. The trustee may nevertheless avail himself of such a right by virtue of the explicit

provision therefor in § 70(e). *If, however, the cause of action is not one embraced within § 70(e) because it does not involve an avoidance of a transfer or obligation, can the trustee assert the cause of action on behalf of the creditors?* The trustee's capacity to assert a cause of action for fraud and conversion belonging to the customers of a bankrupt bucket shop owner against joint tort feasors has been denied, even though the trustee took assignments from the creditors concerned." [Emphasis added.]

Barnes v. *Schatzkin* is cited to the above statement, which is, in necessary effect, a direct statement by Collier that the cause of action asserted in *Barnes*, was not one embraced within § 70(e) because avoidance of a transfer or obligation was not involved. That is precisely what petitioner contends here.

Presumably the statement of the Court of Appeals that the *Barnes* case was decided before the enactment of Section 70(e) refers to that section as amended, since § 70(e) has been has been a part of the Bankruptcy Act since its enactment in 1898. The above quoted language of 4A *Collier on Bankruptcy* (14th ed. 1967), page 149, obviously refers to § 70(e) in its present form. But in any event § 70(e) as it existed at the time the *Barnes* case was decided, provided that the trustee could avoid any transfer by the bankrupt of his property which any creditor might have avoided, and would clearly have been sufficient if the transfers to the defendants had been deemed to be fraudulent transfers which creditors could have avoided because made from funds belonging to the bankrupt's customers, which it had unlawfully converted to purchase securities for its own account. As previously stated, Section 70(e) in its present form provides that "All property of the debtor affected by any such transfer shall be and remain a part of his assets and estate, discharged and released from such transfer and shall pass to, and every transfer or obligation

shall be avoided, by the trustee for the benefit of the estate * * *." As applied to this case, the change of language is not significant.

Moreover, although *Collier* discusses in great detail the changes in § 70 by the amendments in 1938 and thereafter, including their purposes and effects, there is no indication in the text that any change was either made for the purpose, or with the effect, of changing the principles stated in *Barnes* v. *Schatzkin*. The changes in Section 70 by subsequent amendments are analyzed in 4A *Collier on Bankruptcy* (14th ed.), pp. 24-47, and appear in the footnotes on pages 27-34. While one of such major changes is stated to be (p. 34):

> "* * * the trustee's power to avoid transfers of the bankrupt effected in fraud of creditors or other circumstances permitting avoidance under applicable state or federal law have been amplified and clarified;"

there is no suggestion that the definition of fraudulent conveyances has been so enlarged as to enable the Trustee to assert claims of the character *Barnes* v. *Schatzkin* held that he could not assert because they belonged to the individual customers. Nor is there any such suggestion in 4A *Collier on Bankruptcy* (14th ed. 1967), ¶ 70.69(2), pp. 764-767, cited by the Court of Appeals.

Nor has Section 60(e) (11 U. S. C. § 96), although enacted after *Barnes* was decided, effected any change in the legal principles applicable here. The fund established by § 60(e) subparagraph (2), consists of all property at any time received, acquired or held by a stockbroker from or for the account of customers, and the proceeds of all customers property, whether rightfully transferred or wrongfully converted, except property of cash customers able to identify their property in the manner prescribed in § 60(e), subparagraph (4). The fact that the separate and single fund so created includes the proceeds of all customers' property

unlawfully converted by the broker, as well as the proceeds of customers' property rightfully transferred, has no significance with reference to the question presented here since no question with respect to any proceeds in the hands of the trustee is involved.

Subparagraph (5) of § 60(e) upon which the Court of Appeals relies, provides that where the fund created under subparagraph (2) is not sufficient to pay the claims of customers, other than cash customers able to identify their property or the proceeds thereof, within the limitations of subparagraph (4), a transfer of any property which, except for such transfer would have been a part of such fund, may be recovered by the trustee for the benefit of such fund *if such transfer is void or voidable under the provisions of the Bankruptcy Act,* and that *for the purpose of such recovery* the transferred property shall be deemed *to have been the property of the broker.*

The purpose of subparagraph (5) is stated in 3 *Collier on Bankruptcy* (14th ed. 1967), p. 1173, n. 19, quoting from Analysis of H. R. 12889, 74th Cong. 2d Sess. (1936), 193, as follows:

> "Transfers of property by an insolvent stockbroker within four months of his bankruptcy, under circumstances which would make a similar transfer by any other debtor a recoverable preference, have, by reason of the rule, establishing the status of a stockbroker in margin transactions as that of a pledgee, been held to be valid and beyond attack by the trustee. *Richardson v. Shaw* [209 U. S. 365], *Sexton* v. *Kessler,* 225 U. S. 90. The purpose of clause [paragraph] (5) is to make the provision of clause (2) effective, so that when a stockbroker, while insolvent, makes a delivery to some margin customers, when unable to fulfill the same obligation in respect to other customers, the property so transferred shall be recoverable by the trustee if the essentials of a preference or other illegal transfer, as defined in 60, 67, or 70 exist."

The provision of subparagraph (5), that, for the purpose of the recovery, the property transferred shall be deemed to have been the property of the stockbroker is of special significance. Under this language the right of recovery given to the trustee is the right to set aside transfers of property which, if the transferred property had belonged to the bankrupt, would have been void or voidable under the fraudulent transfer provisions of the Act. As previously stated a transfer of funds belonging to the bankrupt would neither be void nor voidable under any of such provisions if made for full value, in the absence of an intention to delay, hinder, and defraud creditors. As applied here, the bankrupt admittedly received full value at the time of such purchase and it is as of that time that the validity of the transfer must be determined. That the value of the consideration received subsequently declined has no bearing on the validity of the transfer and no claim has been or could be made that any payments to petitioner in payment for securities purchased at market were made by the bankrupt for the purpose of delaying, hindering or defrauding creditors. Nor does § 60(e)(5) provide that payments made by the bankrupt from converted funds of its customers shall be void or voidable under the fraudulent transfer provisions of the Bankruptcy Act merely because the bankrupt had no right to use the funds for his own purposes.

Assuming that Congress could have provided that all rights of customers arising out of conversion of their funds by the stockbroker should vest in the trustee, and could be asserted by him for the benefit of all customers included in the class created by subparagraph (2) of § 60(e), it has not done so. That provision does not purport to change or otherwise affect the scope of any of the fraudulent transfer provisions of the Bankruptcy Act. All those provisions deal with transfers of property owned by the bankrupt. Transfers by a stockbroker of customers'

funds or proceeds thereof, which would have been fraudulent under those statutes, including § 70(e), if the transferred property had belonged to the bankrupt, are merely brought within those statutes by the provision of subparagraph (5) of § 60(e) that for the purpose of the recovery the property is deemed to be the property of the stockbroker. There is no suggestion in *Collier on Bankruptcy* that Section 60(e) has in any manner affected the principles announced in *Barnes* v. *Schatzkin*. 4A *Collier on Bankruptcy* (14th ed. 1967), p. 149, clearly indicates the contrary:

> "If, however, the cause is not one embraced within § 70e because it does not involve an avoidance of a transfer or obligation, can the trustee assert the cause of action on behalf of its creditors? The trustee's capacity to assert a cause of action for fraud and conversion belonging to the customers of a bankrupt bucket shop has been denied even though the trustee took assignments from the creditors concerned."

Furthermore, in *Pettit* v. *American Stock Exchange*, 217 F. Supp. 21 (S. D. N. Y. 1963), relied on heavily by the Court of Appeals below for the proposition that Section 60(e) had changed the law of *Barnes* v. *Schatzkin*, the district court made it unmistakably clear that the basis of the claim which the trustees were held entitled to assert, was not fraud against the investors, but fraud against the bankrupt corporation, which deprived it of a valuable asset. The court said (217 F. Supp. at 25):

> "At the heart of this case are two fraudulent transactions in securities. By virtue of one, the initial issuance and distribution to Birrell, the corporation was defrauded of 578,000 shares of its stock, a substantial asset of the corporation. This facet of the scheme comes squarely within Section 10(b), as *Hooper* v. *Mountain States Securities Corp.* makes eminently clear, and gives rise to a corporate cause of action with respect to it."

The Court of Appeals opinion also refers specifically to Count IV of the complaint in *Pettit* v. *American Stock Exchange* which alleged that certain defendant Swiss Banks had participated in the fraud against the bankrupt corporation and were holding the proceeds of the sale of the stock of which the bankrupt was defrauded, with full knowledge of the fraud. It was held in *Pettit* that the trustees were entitled to maintain an action under Section 70(e) of the Bankruptcy Act to recover the proceeds, but since in *Pettit,* the bankrupt corporation itself had been defrauded of its stock by the issuance and distribution thereof without valuable or equivalent consideration, and the Swiss Bank defendants were alleged to be holding the proceeds of the property of which the bankrupt corporation had been defrauded, with full knowledge of the illegal nature of the transactions, the action to recover from them the proceeds of such transfers under § 70(e) was merely a garden variety application of the statute.

The statement in the opinion of the Court of Appeals in this case that the *Pettit* case also held that "the siphoning off of a corporation's assets by insiders constitutes a transaction in fraud of creditors of the corporation" is obviously inapplicable to anything involved here. No siphoning off of the assets of the bankrupt by an insider, or by anyone, is involved here. The losses due to market declines obviously did not constitute a "siphoning off" of assets of the bankrupt.

Furthermore, the Court of Appeals' opinion states that since *Barnes* v. *Schatzkin* is merely a decision of a state court, it is not binding upon the Court of Appeals in interpreting this aspect of the Bankruptcy Act. This ignores the fact that this Court has denied certiorari in *Barnes,* a denial of some significance in bankruptcy law. For although as a general rule the denial of certiorari embodies

no expression of opinion on the merits of the case, the denial of certiorari in *Barnes* led to the general acceptance of the proposition that *Barnes* had rendered the only proper construction of the Bankruptcy Act. See, 2 *Collier on Bankruptcy* (14th ed.) p. 1746; also 4A *Collier on Bankruptcy* (14th ed.) pp. 149 and 391.

Petitioner submits that the principles stated in the *Barnes* case correctly interpreted the provisions of the Bankruptcy Act with respect to the right of the respondent trustee in bankruptcy to maintain an action against petitioner based on the conversion by the bankrupt of the funds of its customers; its use of said funds to purchase securities for its own account, and alleged actual or chargeable knowledge of petitioner of the source of the funds, and that the Court of Appeals was in error in refusing to follow *Barnes* in this case. Under the principles there stated any such right of action belongs to the customers and does not vest in the trustee in bankruptcy and those principles have in no way been impaired by subsequent legislation or judicial decision.

II.

REASONS FOR GRANTING THE WRIT WITH RESPECT TO THE SECOND QUESTION.

This part of the case presents a further important question of federal law which has not been, but should be, settled by this Court: whether stock exchange rules, specifically New York Stock Exchange Rule 405, may imply civil liability. The holding of the Court of Appeals below would impose liability under federal securities laws for the violation of the rules of a stock exchange, if those rules are intended, in some part, for the protection of investors. This holding would transform exchange rules into a new body of federal law, without prior approval or review by Congress or the Securities & Exchange Commission.

This Court has never spoken on whether stock exchange rules are actionable, and under what circumstances. It is a new proposition of law which, in light of the wide publicity given to the Seventh Circuit decision herein is likely to be urged with frequency on many federal courts, leading undoubtedly to divergent holdings unless guidelines are established by this Court.

There is already such divergence in the holdings of the respective Courts of Appeals for the Second and Seventh Circuits. The Second Circuit, in *Colonial Realty* v. *Bache & Co.*, 358 F. 2d 178 (2d Cir. 1966), *cert. denied* 385 U. S. 817 (1966) has laid down the "place in the regulatory scheme" test, which would imply liability only if the exchange rule in question is required by the SEC to effectuate the overall regulatory scheme of the federal securities laws rather than contain an expression of ethical standards which would benefit the entire securities industry, including investors. The Seventh Circuit, on the other hand, has fixed liability in this case by simply asserting that Rule 405 was designed, in part at least, for the protection of investors even though it clearly has no "place in the regulatory scheme" of the Securities & Exchange Commission. Rule 405 requires New York Stock Exchange members to "know their customers" by exercising "(a) * * * due diligence to learn the essential facts relative to every customer, every order, and every cash and margin account accepted by such organization; and (b) [s]upervise diligently all accounts handled by registered representatives of the organization." (Appendix IV, pp. A 33-35.)

The Second Circuit in *Colonial Realty* stated that while it had refused in *O'Neill* v. *Maytag*, 339 F. 2d 764, 770 (2d Cir. 1964) to give general recognition to private rights of action for alleged violations of stock exchange rules, it was possible that a particular rule could play an integral part in SEC

regulation and that it did not wish to say that such a rule could not provide a basis for implying a private right of action. With respect to the test to be applied and its application to the case before it, the court speaking through Judge Friendly, said (358 F. 2d at 182):

> "What emerges is that whether the courts are to imply federal civil liability for violation of exchange or dealer association rules by a member cannot be determined on the simplistic all-or-nothing basis urged by the two parties; rather the court must look to the nature of the particular rule and its place in the regulatory scheme, with the party urging the implication of a federal liability carrying a considerably heavier burden of persuasion than when the violation is of the statute or an SEC regulation. The case for implication would be strongest when the rule imposes an explicit duty unknown to the common law. The rules here at issue, however, are near the opposite pole. Although they do impose a duty upon members not to engage in conduct inconsistent with fair and equitable principles of trade, which the exchange or association can enforce through disciplinary proceedings, they are something of a catch-all which, in addition to satisfying the letter of the statute, preserves power to discipline members for a wide variety of misconduct, including merely unethical behavior which Congress could well not have intended to give rise to a legal claim. We find little reason to believe that by requiring exchanges and dealers' associations to include such provisions in their rules Congress meant to impose a new legal standard on members different from that long recognized by state law."

While *Colonial Realty* foreshadows the possibility that certain exchange rules may ultimately be held to imply federal civil liability for their violation (see, however, the recent expressions of caution by Judge Frankel in *DeRenzis* v. *Levy*, 297 F. Supp. 998, 1001-1002 (S. D. N. Y. 1969)), the holding in the instant case that Rule 405

grounds federal civil liability is the first such holding by a court and is in direct conflict with the holding of the Second Circuit in *Colonial Realty*.

The rule involved in *Colonial Realty*, which required observance by members of the New York Stock Exchange of "high standards of commercial honor and just and equitable principles of trade", is a rule which the Exchange was required to adopt under Section 6, subsection (b), of the Securities Exchange Act of 1934 in order to register under that Act. As made clear by Section 6, subsection (c), an exchange may adopt and enforce any additional rule not inconsistent with the Act and the rules and regulations thereunder. Rule 405 of the New York Stock Exchange is such a rule.

The type of rule which the Second Circuit in *Colonial Realty* said it did not wish to say could not provide a basis for implying civil liability was one which could "play an integral part in SEC regulation notwithstanding the Commission's decision to take a back-seat role in its promulgation and enforcement" (358 F. 2d at 182) and, as stated in the paragraph of the Court's opinion quoted above, the case for implication would be strongest when the rule imposes an *explicit* duty unknown to the common law. An example of such rule stated in Note 4 of the Court's opinion (358 F. 2d at 182) is particularly significant:

> "An example of this type of rule is NYSE Rule 342 which prohibits, in certain cases, a member from voting stock held in a street name without specific instructions from the beneficial owner. See Lowenfels, Implied Liabilities Based Upon Stock Exchange Rules, 66 Colum. L. Rev. 12, 25-28 (1966). The author points out that, doubtless because of the exchange rules, the SEC terminated a rule-making proceeding of its own."

The rule in the suggested example imposes an explicit duty unknown to the common law. On the contrary, Rule 405, like the rule involved in *Colonial Realty*, cannot be said to impose an explicit duty which was known to the common law. Further, all specific obligations contained in the Rule, as spelled out in the Exchange's official Supplementary Material (*cf. DeRenzis* v. *Levy*), have been complied with, including the obtaining of the bankrupt's corporate charter and the necessary authorizations to trade. See Appendix IV, pp. A 33-A35 as well as the Schroeder affidavit in support of summary judgment (Cert. App. pp. 39-70).

The Court in *Colonial Realty* made it quite clear that the type of exchange rule which would ground federal civil liability is one which "provides what amounts to a substitute for regulation by the SEC itself." 358 F. 2d at 182. The adoption of Rule 452 by the New York Stock Exchange resulting in the termination of a rule-making proceeding by the SEC itself provides an instance of an exchange rule serving as a substitute for SEC regulation. It is significant that there is no claim of a similar history for Rule 405. Indeed, the SEC by its adoption of Rule 10b-5 and other rules under the anti-fraud provisions of the Securities Exchange Act of 1934 and the Securities Act of 1933 has taken action to regulate the conduct of customers' accounts by brokers and has afforded ample remedies to customers for failure on the part of brokers to meet the standards set up by the SEC. The very existence of Rule 10b-5, on which respondent additionally relies for recovery against petitioner, appears to establish beyond argument that Rule 405 is *not* a substitute for SEC regulation. Since the Court of Appeals in this case has characterized the facts alleged by the respondent to substantiate its claim of a violation of Rule 405 as "tantamount to fraud"—and thus presumably within the proscription of Rule 10b-5—the holding of the Court of Appeals below

that a violation of Rule 405 can *also* give rise to federal civil liability is plainly erroneous. If, on the other hand, Rule 405 is held to be designed to encompass mere errors of judgment or acts of negligence it cannot be said the rule plays an integral part in federal securities regulation or is a substitute for SEC regulation since, as the Court in *Hecht* v. *Harris, Upham & Co.*, 283 F. Supp. 417 (N. D. Cal. 1968), stated at 430, the thrust of the Securities Act of 1933 and the Securities Exchange Act of 1934 is directed against fraud and not acts such as negligence for which customers have remedies under State law.

A New York Stock Exchange guide, which is described as "A guide to systems as suggested by a Committee of the Member Firm Community," states with respect to the "Know Your Customer" portion of Rule 405 (R. 113):

> "The language of the rule, while broad, is so written as to leave to the firm's judgment what facts are essential in the varying circumstances of each new account."

The broad language of Rule 405, especially in the light of the material in the New York Stock Exchange guide referred to above, makes it clear that, like the rule held not to give rise to civil liability in *Colonial Realty*, Rule 405 also covers a wide variety of conduct which could not reasonably be intended to give rise to a legal claim under the federal securities laws. Clearly, some exchange rules are designed to raise the ethical standards of the members of the exchange without exposure to legal sanctions. Cf. *Silver* v. *New York Stock Exchange*, 373 U. S. 341, 367, 371 (1963) (dissenting opinion). If failure to comply with the requirements of such rules is to result in federal civil liability on the part of members it can be predicted that the gradual and wholesome elevation of ethical standards through the medium of rule-making by exchanges will be discouraged.

Furthermore, the language of Rule 405 is broad enough to apply not only to particular acts or omissions about which there might be little or no difference of opinion, but equally to other acts and omissions as to which there could be radical differences of view. *Interstate Circuit etc.* v. *Dobbs,* 390 U. S. 676 (1968); *Connally* v. *General Const. Co.,* 269 U. S. 385, 391 (1926); *United States* v. *Cohen Grocery Co.,* 255 U. S. 81, 65 L. Ed. 520-521 (1921).

In *Hecht* v. *Harris, Upham & Co., supra,* plaintiff attempted to base a claim against a securities dealer in a discretionary account upon, among other things, violation of a rule of the National Association of Securities Dealers, providing that:

> "In recommending to a customer the purchase, sale, or exchange of any security, a member shall have reasonable ground for believing that the recommendation is suitable for such customers as to his other security holdings and as to his financial situation and needs." 283 F. Supp. at p. 430, quoting Art. III, § 2 of the N. A. S. D. Rules.

While the court said it was unnecessary under the facts to determine whether a dealer could be held liable under the federal securities acts for violation of the rule, its discussion is pertinent. It said (283 F. Supp. at 430, 431):

> "Plaintiff contends that the securities and commodities recommended and bought and sold for plaintiff's account were 'unsuitable' within the meaning of Art. III, Sec. 2, of the Rules of the National Association of Securities Dealers.
>
> "On this point we merely note that the Security Acts, as applicable to this case, are essentially directed at *fraud*—not against mere negligence or errors of judgment on the part of the broker—not against mere negligence or error of judgment on the part of the broker, . . .

"It has been held that, although there may be implied civil liability on the part of a broker under the Securities Exchange Act for violations of certain kinds of exchange or dealer association rules (e.g. rules which merely amount to a substitute for regulation by the S. E. C. itself), no implied civil liability may be predicated on rules which give power to discipline members for certain kinds of misconduct, including merely unethical behavior, which Congress could well not have intended to give rise to a legal claim, e.g., conduct which, although unethical under the association or exchange rules, does not amount to a fraud within the meaning of the fraud provisions of the Act itself. *Colonial Realty* v. *Bache & Co.*, 358 F. 2d 178 (2d Cir. 1966).

"As to the NASD 'suitability' rule (Art. III, Sec. 2, above quoted), upon which plaintiff relies in part in this case, the question arises whether it is the kind of rule upon which a civil action for damages by the customer can be based. Conceivably, a broker might honestly think that his 'ground' for believing his recommendation 'suitable' is 'reasonable', only to find himself overruled in a lawsuit and found guilty of fraud notwithstanding his good faith. As pointed out by Friendly, J., in *Colonial, supra,* p. 182 the practical consequences of allowing private federal damage suits based on rules of this kind, and involving judicial review of market judgments, would be considerable."

The question whether Rule 405 plays an integral part in federal securities regulation and is a substitute for SEC regulation is, as the Court said in *Colonial Realty,* "an issue of general importance under the securities laws." 358 F. 2d at 180. The practical consequences of allowing private federal damage suits based on a rule of the character of Rule 405, involving judicial review of brokers' judgments with respect to "due diligence" and "the essential facts", would be considerable. As indicated above, the holding of the Court of Appeals below will discourage a

stock exchange from adopting experimental rules in an effort to raise the ethical standards of its community. And as Judge Friendly has stated in *Colonial Realty* (358 F. 2d 183):

> "Moreover, mere recitation of the statutory watchword by an aggrieved investor would saddle the federal courts with garden-variety customer-broker suits, even though the controversy was between citizens of the same state, the sum in question did not attain the jurisdictional amount required by 28 U. S. C. § 1331, and there was no indication that the case would be decided differently under state law—unless we were to make the large assumption that by requiring adoption of rules embodying this phrase Congress meant the federal courts to develop a new body of broker-customer law. Indeed, if § 27 were read to include exchange rules, the jurisdiction of the federal courts would be exclusive, and the state courts would be altogether stripped of power to adjudicate claims so pleaded even between their own citizens. See Loss, Securities Regulation, 996-99, 2005-06 (1961)."

The opinion of the Court of Appeals in this case states (Appendix I, p. A13) that:

> "The touchstone for determining whether or not the violation of a particular rule is actionable should properly depend upon its design 'for the direct protection of investors.' * * * Here one of the functions of Rule 405 is to protect the public, [illegible]hat permitting a private action for its violation is entirely consistent with the purposes of the statute."

This test was, as noted by the Court of Appeals in this case, first advocated in a law review article by Lewis D. Lowenfels of the New York Bar [*Implied Liabilities Based Upon Stock Exchange Rules*, 66 Col. L. Rev. 12 (1966)]. The rule charged to have been violated in *Colonial Realty*, requiring exchange members to observe high standards of commercial honor and just and equitable principles of

trade, could have had no conceivable purpose other than protection of the investing public. Lowenfels expressly so recognized in his article, written after the decision of the district court in *Colonial Realty* v. *Bache & Co.*, '61-'64 CCH Fed. Sec. L. Rep. ¶ 91,351 (S. D. N. Y. 1964), and prior to the decision of the Court of Appeals. 66 Col. L. Rev. at 23. The affirmance by the Court of Appeals in *Colonial Realty* necessarily rejected the public protection test advocated by Lowenfels and adopted by the Court of Appeals in this case. This simplistic test not only falls far short of the test announced by the Second Circuit in *Colonial Realty* but is demonstrably in conflict with the principle of that case.

CONCLUSION.

For the reasons above set forth it is respectfully submitted that this petition for certiorari should be granted and the judgment of the Court of Appeals should be reversed.

Respectfully submitted,

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APPENDIX I.

IN THE UNITED STATES COURT OF APPEALS
For the Seventh Circuit

September Term, 1968 — January Session, 1969

No. 17136
DONALD W. BUTTREY, Trustee in Bankruptcy for DOBICH SECURITIES CORPORATION,
Plaintiff-Appellee,
v.
MERRILL LYNCH, PIERCE, FENNER & SMITH, INC.,
Defendant-Appellant.

Appeal from the United States District Court for the Southern District of Indiana, Indianapolis Division.

April 17, 1969

Before CASTLE, *Chief Judge,* and SWYGERT and CUMMINGS, *Circuit Judges.*

CUMMINGS, *Circuit Judge.* This appeal under 28 U.S.C. § 1292(b) involves the question whether defendant was entitled to summary judgment with respect to Counts I, II and III of the complaint. We approve of the district court's action in overruling the defendant's motion for summary judgment.

Plaintiff is the trustee in bankruptcy for Dobich Securities Corporation ("the bankrupt") which had engaged in the sale of securities as a dealer licensed by the State of

Indiana. The bankrupt was organized in October 1963 by Michael Dobich, an individual broker-dealer who was then allegedly insolvent. Defendant Merrill Lynch, Pierce, Fenner & Smith, Inc. is a well-known, nation-wide securities dealer and maintains an office in Indianapolis.

According to Count I of the complaint, in December 1963, defendant granted Michael Dobich's request to open a cash account in Indianapolis in the bankrupt's name for the purpose of trading in securities, and Michael Dobich thereafter began to purchase and sell securities in this account. Count I alleges that defendant knew that Michael Dobich was using fraudulently converted property of various customers of the bankrupt in the relevant security transactions with defendent. In its dealings with the bankrupt, defendant assertedly violated Rule 405, the "Know Your Customer Rule" or "The Rule of Due Diligence," of the New York Stock Exchange adopted pursuant to Section 6 of the Securities and Exchange Act of 1934 (15 U. S. C. § 78f), supposedly causing a net loss to the bankrupt of $460,000 plus $55,000 in commissions paid, or a total of $151,000.

Count II was based on the same factual allegations and alleged that the "natural result of such course of business by the defendant operated as a fraud or deceit" upon the bankrupt in violation of Section 17 of the Securities Act of 1933 (15 U. S. C. § 77q) and Rule 10b-5 of the Securities and Exchange Commission (17 C. F. R. § 240.10b-5) promulgated under Section 10 of the Securities and Exchange Act of 1934 (15 U. S. C. § 78j).

Count III claimed that defendant knowingly aided, abetted and assisted Michael Dobich in violation of Section 17 of the Securities Act of 1933 and SEC Rule 10b-5. Counts II and III also sought the recovery of $515,000.

As the district court noted, in these three counts plain-

tiff is asserting creditors' rights to avoid corporate transactions between the bankrupt and defendant. He is seeking to recover net transfers to defendant by the bankrupt in fraud of its customers. Defendant counters that only the customers of the bankrupt can file actions of this type. However, the district court concluded that the bankruptcy trustee was the proper party to prosecute the alleged causes of action, and that each of these counts adequately states a claim. Therefore, summary judgment was denied to defendant.

Authority of Bankruptcy Trustee to Sue

The trustee in bankruptcy is attempting to avoid the bankrupt's transfers to defendant on the ground that they were fraudulent or voidable under Federal law as to the bankrupt's creditors. This theory is supported by Section 70e of the Bankruptcy Act, providing in part as follows (11 U. S. C. § 110(e)):

> "(1) A transfer made or suffered or obligation incurred by a debtor adjudged a bankrupt under this title which, under any Federal or State law applicable thereto, is fraudulent as against or voidable for any other reason by any creditor of the debtor, having a claim provable under this title, shall be null and void as against the trustee of such debtor.
>
> "(2) All property of the debtor affected by any such transfer shall be and remain a part of his assets and estate, discharged and released from such transfer and shall pass to, and every such transfer or obligation shall be avoided by, the trustee for the benefit of the estate: *Provided, however*, That the court may on due notice order such transfer or obligation to be preserved for the benefit of the estate and in such event the trustee shall succeed to and may enforce the rights of such transferee or obligee. The trustee shall reclaim and recover such property or collect its value from and avoid such transfer or obligation against whoever may hold or have received it, except

> a person as to whom the transfer or obligation specified in paragraph (1) of this subdivision is valid under applicable Federal or State laws."

The transfers which the trustee is attempting to set aside are the bankrupt's payments to defendant from funds belonging to the bankrupt's customers and which had been unlawfully converted by the bankrupt to purchase securities for its own account. The trustee is not seeking to recover the full amount of the claims of the bankrupt's customers but only the net amount of the transfers by the bankrupt to defendant. By virtue of Section 70e(1), if under Federal law these transfers were "fraudulant as against or voidable * * * by any creditor" of the bankrupt, Section 70e(2)[1] empowers the trustee to avoid the transfers "irrespective of the existence of such a cause of action in the bankrupt.'" 3 Remington on Bankruptcy § 1587 (Rev. ed. 1957).

Although Section 70 of the Bankruptcy Act was the principal basis for the district court's decision that the bankruptcy trustee could prosecute this action, its decision is also supported by Section 60e of the Act. Subparagraph (2) of that Section establishes a fund consisting of the proceeds of a bankrupt stockbroker's customers' property unlawfully converted by the stockbroker. In turn, subpara-

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1. An additional source of authority to avoid the challenged transfers may be found in Section 70c (11 U. S. C. § 110 (c)), which was enacted in 1938 and provides in pertinent part:

> "The trustee, as to all property, whether or not coming into possession or control of the court, upon which a creditor of the bankrupt could have obtained a lien by legal or equitable proceedings at the date of bankruptcy, shall be deemed vested as of such date with all the rights, remedies, and powers of a creditor then holding a lien thereon by such proceedings, whether or not such a creditor actually exists.'

In view of the applicability of Section 70e to the present facts, we do not pause to examine the extent to which the above-quoted "strong-arm clause" overlaps, supplements or supplants Section 70e. See 4A Collier on Bankruptcy ¶ 70.48[2] (14th ed. 1967).

graph (5) of Section 60e provides in part (11 U. S. C. § 96(e)(5)):

> "Where such single and separate fund is not sufficient to pay in full the claims of such single and separate class of creditors, a transfer by a stockbroker of any property which, except for such transfer, would have been a part of such fund may be recovered by the trustee for the benefit of such fund, if such transfer is voidable or void under the provisions of this title. For the purpose of such recovery, the property so transferred shall be deemed to have been the property of the stockholder and, if such transfer was made to a customer for his benefit such customer shall be deemed to have been a creditor, the laws of any State to the contrary notwithstanding. * * *"

It should be noted that this provision specifically empowers the trustee to recover the property transferred by the bankrupt stockbroker "if such transfer is voidable or void under the provisions of this title." As we have already seen, Section 70e declares this transfer voidable if contrary to Federal law, as alleged here.[2]

In opposition to the foregoing interpretation, the defendant relies principally on *Barnes* v. *Schatzkin*, 212 N. Y. S. 536, 215 App. Div. 10 (1925), affirmed, 242 N. Y. 552, 152 N. E. 424 (1926), certiorari denied, 273 U. S. 709. There a "bucket shop" brokerage firm converted its customers' funds by purchasing securities for its own account from defendants, members of the New York Stock Exchange,

2. Both parties have treated this complaint as having charged the bankrupt with a fraudulent transfer of the customers' funds to defendant. Therefore, we need not consider whether the complaint is also sustainable on the theory that Michael Dobich and defendant defrauded the bankrupt by investing funds entrusted to it and contrary to the authorization of its customers. Any losses thereby incurred by the bankrupt would deplete its estate and might be considered a fraud on its creditors, so that Section 70e would permit the trustee to sue. *See Pettit* v. *American Stock Exchange*, 217 F. Supp. 21, 25, 30-31 (S. D. N. Y. 1963).

who allegedly had knowledge of the fraudulent conversions. Upon the bankruptcy of the brokerage firm, its customers assigned to the bankruptcy trustee their claims against the defendants as aiders and abetters of the bankrupt. Although holding that the trustee was without legal capacity to maintain the action on the assignments,[3] the court noted that Section 70 of the Bankruptcy Act does permit a trustee "to recover property * * * transferred * * * in fraud of creditors, or the like" (at 212 N. Y. S. 539). In *Barnes*, it appears that the trustee was attempting to recover the full amount of the claims of the customers as their assignee, whereas here the bankruptcy trustee is seeking to recover on the theory that there was a fraudulent transfer made by the bankrupt to the defendant, entitling the trustee to recover the net amount of those transfers.

To support its conclusions in *Barnes*, the court insisted that a debtor-creditor relationship must exist between the transferee and the bankrupt, but it is now settled that such a relationship is not required. *Pettit* v. *American Stock Exchange*, 217 F. Supp. 21 (S. D. N. Y. 1963).

In *Barnes*, the court also observed that the bankrupt could not recover because it was responsible for the illegal transaction. Not only was this view rejected in the *Pettit* case, but also in *Schneider* v. *O'Neill*, 343 F. 2d 914 (8th Cir. 1957), where the court observed (at p. 918):

"While it is unquestionably true that the trustee stood

3. It is for this narrow point that *Barnes* is cited in 2 Collier on Bankruptcy (14th ed. 1968), pp. 391, and 1746; 4A *Id.* p. 149. (14th ed. 1967). In *Barnes*, Judge Finch wrote a persuasive dissent based on an unreported opinion of Judge Learned Hand. Until the present case, the *Barnes* case has not been cited judicially since the year after its affirmance and may no longer represent the view of the New York courts. See *Tchlenoff* v. *Jacobs*, 44 N. Y. S. 2d 38, 39 (Sup. Ct. 1943), affirmed, 267 App. Div. 908, 46 N. Y. S. 2d 875, affirmed, 293 N. Y. 904, 60 N. E. 2d 32 (1944).

> in the shoes of the bankrupt, it is equally true that he stood in the overshoes of the creditors * * *."

There it was held that under Section 70e, the trustee has rights and powers on behalf of creditors that are unaffected by the fact that he could not have recovered if he stood only in the shoes of the bankrupt. Even the defendant's reply brief concedes that under Section 70e a trustee is vested with the rights of creditors and is not limited to the rights of the bankrupt. See *Globe Bank & Trust Co.* v. *Martin*, 236 U. S. 288, 297; 4A Collier on Bankruptcy ¶ 70.71 at p. 786 (14th ed. 1967); 3 Remington on Bankruptcy § 1587 note 13.1 (1968 Supp.).

In our view, the *Barnes* case did not face and reject the transfer theory urged here. It was decided before the enactment of Sections 70e and 60e on which this trustee relies. And any lingering doubts about the scope of the trustee's authority under Section 70e have been eliminated by the recasting of that provision in 1938. 4A Collier on Bankruptcy ¶ 70.69[2] (14th ed. 1967). Furthermore, being a decision of a state court, the case is not binding upon us in interpreting this aspect of the Bankruptcy Act. *Barnes* does not bar the trustee from maintaining this action.

Defendant also relies upon *Nicklaus* v. *Bank of Russellville*, 336 F. 2d 144 (8th Cir. 1964), for the proposition that the trustee is without authority to assert a claim for possession of property fraudulently converted by the bankrupt and subsequently transferred. There, however, the dispute was between the trustee and the rightful owner, and it was undisputed that the bankrupt had obtained the property by means of a fraud upon the defendant bank. A state court had already obtained *in rem* jurisdiction of the property prior to the institution of bankruptcy, and the Court of Appeals held that the state court's jurisdiction was not abated by the bankruptcy. Therefore, it affirmed

the district court's ruling that the bankruptcy trustee must present his claims to the property in the state proceedings. In the course of its opinion, the court stated (at p. 147):

> "In the case at bar appellant, as Trustee in Bankruptcy, does not state even a colorable claim as to his title or right to possession of the property here considered. It is apparent that the fraud, which he admits existed, was not perpetrated against his bankrupt; or by a person who received possession of property rightfully belonging to his bankrupt. Property obtained by fraud of the bankrupt, or by other tort, is not properly a part of the assets of a bankrupt's estate."

Here, conversely, the trustee is asserting the right of the defrauded customers of the bankrupt to recover property obtained by the defendant's fraud upon the bankrupt or its customers. Thus the position of the defendant bank in *Nicklaus* is more like that of the customers in the present case than like that of the defendant Merrill Lynch, but the difference is that the bank sued in its own right prior to the filing of the petition for bankruptcy rather than filing any claims against the bankrupt or electing to treat the bankrupt as its debtor. Here the customers of the bankrupt have filed their claims with the trustee and have made that election. Accordingly, *Nicklaus* does not support the defendant's argument that the bankruptcy trustee has no authority to bring this action.

Defendant attempts to distinguish *Pettit* v. *American Stock Exchange*, 217 F. Supp. 21 (S. D. N. Y. 1963), cited in the opinion below. Count IV of the complaint in that case alleged that certain Swiss banks had aided and abetted in certain fraudulent transfers of shares of the bankrupt corporation. The bankruptcy trustee sought to recover the proceeds of the fraud by means of a suit to avoid the transfers under Section 70e. It has already been noted that the *Pettit* complaint supported a cause of action for

fraud against the bankrupt, to which the trustee succeeded.[4] However, the court also held that "the siphoning off of a corporation's assets by insiders constitutes a transaction in fraud of creditors of the corporation" (at p. 31). For this reason, the *Pettit* case lends support to either theory on which the present complaint is sustainable.

In an attempt to show that only the creditors should be permitted to sue here, defendant cites *Brennan* v. *Midwestern United Life Insurance Co.*, 259 F. Supp. 673 (N. D. Ind. 1966), appeal docketed No. 17167 (7th Cir. September 9, 1968). That was a class action on behalf of the customers of Dobich Securities Corporation against one of the insurance companies in whose stock Dobich Securities specialized. The complaint alleged that the defendant permitted Dobich Securities to create an artificial market for the defendant's stock by soliciting orders with the intent of converting the purchase money to its own use, redounding to the benefit of defendant by bettering its position in certain merger negotiatons. That case is distinguishable for several reasons. No transfer was alleged from the bankrupt to the defendant, and there was no claim that the action could or should have been bought by the bankruptcy trustee. It appears that the complaint in the *Brennan* case contemplated crediting any dividend received by the customers in the bankruptcy against the recovery from the defendant. Accordingly, the remedy approved by the district court in *Brennan* complements rather than conflicts with the trustee's power to avoid fraudulent transfers, and we need not decide when a creditor's cause of action may be preempted by the supervening bankruptcy of his debtor. See 2 Collier on Bankruptcy ¶ 47.05[1] at p. 1745 (14th ed. 1968); 4A *Id.* ¶ 70.92[2] (14th ed. 1967). Permitting the bankruptcy trustee to maintain this action will accord with the purposes of the Bankruptcy Act and

4. See note 2, *supra*.

avoid multiple individual or complex class actions that might result in inequitable distributions of the assets of the bankrupt estate.[5] Of course, our decision that the trustee may maintain this action in no way prejudges the merits of his claim.

Violation of Rule 405 of New York Stock Exchange May Be Actionable.

Pursuant to Sections 6 and 19 of the Securities and Exchange Act of 1934 (15 U. S. C. §§ 78f and 78s), the New York Stock Exchange adopted Rule 405 providing:

> "Every member organization is required through a general partner or an officer who is a holder of voting stock to
>
> (1) Use due diligence to learn the essential facts relative to every customer, every order, every cash or margin account accepted or carried by such organization and every person holding power of attorney over any account accepted or carried by such organization.
>
> (2) Supervise diligently all accounts handled by registered representatives of the organization.
>
> (3) Specifically approve the opening of an account prior to or promptly after the completion of any transaction for the account of or with a customer, provided, however, that in the case of branch offices, the opening of an account for a customer may be approved by the manager of such branch office but the action of such branch office manager shall within a reasonable time be approved by a general partner or an officer who is a holder of voting stock in the organization. The member, general partner or officer approving the opening of the account shall, prior to giving his approval, be personally informed as to the essential facts relative to the customer and to the nature of the proposed account and shall indicate his approval in

5. See *Pettit* v. *American Stock Exchange,* 217 F. Supp. 21, 27, 28 (S. D. N. Y. 1963).

writing on a document which is a part of the permanent records of his office or organization."

The first count of this complaint asserts that the defendant violated this Rule by various "acts and omissions" resulting in $515,000 damages to plaintiff. For purposes of defendant's motion for summary judgment, we must take as true those acts and omissions described in the complaint. The pertinent allegations are that Michael Dobich was financially unstable and was a big speculator in securities and commodities. In 1962, he issued three large checks to defendant to pay for securities, and the checks were returned for insufficient funds. Defendant suspended him from trading in commodities because of his erratic trading practices. Nevertheless, in December 1963, defendant granted Michael Dobich's request to open a cash account in the name of the bankrupt, of which he was the sole shareholder and principal officer. Defendant authorized the opening of that account without receiving any financial statements, bank references, or credit reports as to the bankrupt. Moreover, defendant did not determine whether the bankrupt filed the requisite financial condition report with the Securities and Exchange Commission, nor did defendant ascertain whether the securities transactions would be for the bankrupt as principal or as agent. Defendant is also alleged to have known after January 20, 1964, that the money used by Michael Dobich in the bankrupt's securities transactions belonged to its customers and was fraudulently converted. In February 1964, defendant changed the bankrupt's cash account to a margin account without investigating its financial ability. Thereafter, defendant permitted Michael Dobich to speculate in large stock transactions for the bankrupt, including "block trading," "day trades," and "short sales." From January through May 1964, defendant purportedly failed to supervise the bankrupt's account properly. The various

losses sustained by the bankrupt in trading with defendant resulted in its insolvency.

From the foregoing allegations, the district court concluded that defendant was charged with "an almost callous disregard of Rule 405" and its purpose to protect the public. After noting that Rule 405 also served a non-actionable "housekeeping" function for the New York Stock Exchange, the court decided that a violation of the public protection function of Rule 405 would be actionable.

In *J. I. Case Co.* v. *Borak*, 377 U. S. 426, the Supreme Court held that private suits for damages were impliedly authorized by the Securities Exchange Act of 1934, stating (at p. 432):

> "Private enforcement of the proxy rules [of the Securities and Exchange Commission] provides a necessary supplement to Commission action. As in antitrust treble-damages litigation, the possibility of civil damages * * * serves as a most effective weapon in the enforcement of the proxy requirements."

This holding was recently reaffirmed in *Allen* v. *State Board of Elections*, 37 U. S. L. W. 4168, 4171.

Using the *Borak* case as a springboard, in *Colonial Realty Corporation* v. *Bache & Co.*, 358 F. 2d 178 (2d Cir. 1966), certiorari denied, 385 U. S. 817, Judge Friendly noted that Stock Exchange rules can play an integral part in SEC regulation. The Court summed up this principle as follows (at p. 182):

> "What emerges is that whether the courts are to imply federal civil liability for violation of exchange or dealer association rules by a member cannot be determined on the simplistic, all-or-nothing basis urged by the two parties; rather, the court must look to the nature of the particular rule and its place in the regulatory scheme, with the party urging the implication of a federal liability carrying a considerably heavier

> burden of persuasion than when the violation is of the statute or an SEC regulation. The case for implication would be strongest when the rule imposes an explicit duty unknown to the common law."

The jurisdictional provision of the Securities and Exchange Act of 1934 is contained in Section 27 and provides in part as follows (15 U. S. C. § 78aa):

> "The district courts of the United States, and the United States courts of any Territory or other place subject to the jurisdiction of the United States shall have exclusive jurisdiction of violations of this chapter or the rules and regulations thereunder, and of all suits in equity and actions at law brought to enforce any liability or duty created by this chapter or the rules and regulations thereunder."

There is nothing inconsistent with this Section in holding that violations of Rule 405 may be actionable as a "duty created by this chapter" inasmuch as Rule 405 was promulgated in accordance with Sections 6 and 19 of the Act, even if Rule 405 is not in itself to be considered a rule "thereunder." See Lowenfels, "Implied Liabilities Based Upon Stock Exchange Rules," 66 Colum. L. Rev. 12, 18-19 (1966). The touchstone for determining whether or not the violation of a particular rule is actionable should properly depend upon its design "for the direct protection of investors." *Id.* at p. 29. Here one of the functions of Rule 405 is to protect the public, so that permitting a private action for its violation is entirely consistent with the purposes of the statute.

We do not decide that an alleged violation of Rule 405 is *per se* actionable. However, Count I pertains to the defendant's acceptance of investments without regard for the bankrupt broker's defalcations of investors' funds. Such a breach of fair practice undermines the protection of investors and surely "play[s] an integral part in SEC

regulation'' of Exchanges and their members. *Colonial Realty Corporation* v. *Bache & Co., supra,* at p. 182. As the Supreme Court stated in *Silver* v. *New York Stock Exchange,* 373 U.S. 341, 355:

> ''It is no accident that the Exchange's Constitution and rules are permeated with instances of regulation of members' relationships with non-members including non-member broker-dealers. A member's purchase of unlisted securities for itself or on behalf of its customer from a boiler-shop operation creates an obvious danger of loss to the principal in the transaction, and sale of securities to a non-member insufficiently capitalized to protect customers' rights creates similar risks. In addition to the potential financial injury to the investing public and Exchange members that is inherent in these transactions as well as in dealings with non-members who are unreliable for any other reason, all such intercourse carries with it the gravest danger of engendering in the public a loss of confidence in the Exchange and its members, a kind of damage which can significantly impair fulfillment of the Exchange's function in our economy. Rules which regulate Exchange members' doing of business with non-members in the over-the-counter market are therefore very much pertinent to the aims of self-regulation under the 1934 Act. Transactions with non-members under the circumstances mentioned can only be described as 'inconsistent with just and equitable principles of trade,' and rules regulating such dealings are indeed 'just and adequate to insure fair dealing and to protect investors.' ''

Although mere errors of judgment by defendant might not support a federal cause of action, the facts alleged here are tantamount to fraud on the bankrupt's customers, thus giving rise to a private civil damage action. See *Hecht* v. *Harris Upham & Co.,* 380 F. Supp. 417, 430, 431 (N.D. Cal. 1968).

In *Butterman* v. *Walston & Co.,* 387 F. 2d 822 (7th Cir.

1967), after trial on the merits, judgment for defendant stockbroker was rendered on counts alleging violations of Stock Exchange rules, but neither the trial court nor this Court intimated that such counts failed to state a federal cause of action. We held that the New York Stock Exchange had no liability "because of violation of its rules where it had no knowledge, or reasonable way of gaining knowledge, of alleged violations, and no duty to enforce its rules against violators until it had or should have the knowledge of violation or supposed violation" (at p. 825). In contrast, various supposed violations of Rule 405 are spelled out in this complaint, with knowledge ascribed to defendant. Until this case is actually tried, it will be impossible to ascertain whether defendant has violated Rule 405, and if so, whether the violations justify the imposition of liability.

Defendant's final argument is that its alleged violation of Rule 405 did not proximately cause the bankrupt's losses. It is urged that investment decisions were made solely by the bankrupt and that any loss in value of securities purchased by it was due to declines in the market generally. But the result of defendant's allegedly "callous disregard" for the "Know Your Customer" rule was to permit the financially irresponsible president of the bankrupt to use defendant's facilities for the purpose of speculating with funds converted from the bankrupt's customers. If proved, we can fairly say that "the conduct of the defendants in permitting the use of the account and in failing to properly supervise it paved the way for the losses suffered by these plaintiffs." *Hawkins v. Merrill Lynch, Pierce, Fenner & Beane*, 85 F. Supp. 104, 122 (W. D. Ark. 1949). To allow brokers to escape liability under such circumstances by blaming the known defalcator's losses on a market drop would offend public policy and the ameliorative purposes of the securities law and the rules and regu-

lations. We are unable to sustain the proximate cause defense as to any of the counts involved in this appeal.

Violations of Section 17 of the Securities Act and SEC Rule 10b-5.

Counts II and III are predicated on defendant's violations of Section 17 of the Securities Act of 1933 and Rule 10b-5 of the Securities and Exchange Commission. Section 17 makes it unlawful for a seller of securities "to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser" (15 U. S. C. § 77q). Rule 10b-5 proscribes the same activities "in connection with the purchase or sale of any security" (17 C. F. R. § 240.10b-5). Count II charges defendant as a principal and Count III as an aider and abettor.

Defendant asserts that the only sales relevant to any violation of the Securities Act and Rule 10b-5 are those between the bankrupt and defendant. From this, defendant reasons that since there are no allegations that Merrill Lynch defrauded the bankrupt in connection with these sales,[6] there can be no predicate for violation of the Securities Act. However, it is well settled that parties may be liable for violations of the Act and Rule 10b-5 as long as they engage in fraudulent activity "in connection with" the sale or purchase of securities or in a fraudulent "course of business." Here it is alleged that defendant knew or should have known of the bankrupt's scheme to convert securities investment funds and nevertheless enabled the bankrupt to engage in large-scale speculations with its customers' funds through defendant's office. Without entering the debate as to the precise status of defendant as a "buyer" or a "seller," we are persuaded that Count II sufficiently alleges that defendant benefited

6. Compare note 2, *supra*.

by a course of business which operated as a fraud upon the bankrupt's customers to entitle those customers, through the trustee in bankruptcy, to recover the net transfers of the funds so converted. Cf. *Cooper* v. *North Jersey Co.*, 226 F. Supp. 972, 978 (S. D. N. J. 1964); *Pettit* v. *American Stock Exchange*, 217 F. Supp. 21, 28 (S. D. N. Y. 1963).

Defendant does not appear to contest that the bankrupt's activities in converting its customers' funds to its own use constituted violations of the securities laws. See *SEC* v. *Kelly*, CCH Fed. Sec. L. Rep. (1948-1952 Decisions) ¶ 90,497 (N. D. Ill. 1951). Defendant argues that its alleged participation in this fraud or deceit could not give rise to liability for aiding and abetting because no corporate cause of action arises in favor of the trustee to protect the defrauded customers. For the reasons discussed above in connection with the trustee's authority to sue, we reject this argument and hold that Count III states a cause of action for aiding and abetting in violation of the Securities Act and Rule 10b-5 and presenting issues of fact suitable for trial on the merits. See *Brennan* v. *Midwestern Life Insurance Co.*, 359 F. Supp. 673, 682 (N. D. Ind. 1966).

The judgment of the district court is affirmed.

APPENDIX II.

UNITED STATES DISTRICT COURT.

(Caption—IP 66-C-210)

ENTRY FOR JUNE 28, 1967.

This cause came before the Court upon a motion filed by the defendant, Merrill Lynch, Pierce, Fenner & Smith, Inc., pursuant to Rule 56, Federal Rules of Civil Procedure, entitled "Defendant's Motion for Summary Judgment with Respect to Plaintiff's First, Second, Third, Fourth and Fifth Causes of Action." The plaintiff, by his counsel, at the oral argument, voluntarily dismissed with prejudice, plaintiff's Fourth Cause of Action (Count IV of the Complaint), to which defendant made no objection.

The Court having heretofore heard arguments of counsel, considered the pleadings, depositions and affidavits on file, and considered the briefs filed herein by the parties, and being duly advised in the premises, now finds as follows:

1. Plaintiff is asserting in this action a creditor's right to avoid corporate transactions between the bankrupt Dobich Securities Corporation and the defendant. Plaintiff seeks to recover amounts he contends were transferred to the defendant by the bankrupt in fraud of the creditors of the bankrupt. The defendant insists that such actions can be brought only by such creditors and relies primarily on *Barnes* v. *Schatzkin*, 212 N. Y. S. 536 (App. Div., 1925) for this proposition. The Court is of the opinion, however, that the plaintiff is the proper party to prosecute the alleged causes of action, in view of Section 70 of the

Bankruptcy Act, as amended in 1938 and thereafter. Further, the Court believes that there are serious practical obstacles to the successful prosecution of a lawsuit on behalf of an extremely large and scattered class of persons, as we have here, each of whose potential recovery is limited. Compare *Pettit* v. *American Stock Exchange*, 217 F. Supp. 21, 27, 28 (D. N. Y., 1963). The avoidance of multiple individual actions or complex class actions is not only a salutary but a necessary goal of courts in these days of crowded dockets and complex litigation. The Court is further impressed by the fact that *Barnes* v. *Schatzkin, supra*, was decided prior to the enactment of the Securities Act of 1933, the Securities Exchange Act of 1934, and the 1938 and subsequent amendments to Section 70(c) of the Bankruptcy Act.

2. Plaintiff's First Cause of Action (Count I of the Complaint) involves an alleged violation of Rule 405 of the New York Stock Exchange,[1] the so-called "know your customer" rule. The rules adopted by the Exchange would

1. Rule 405 of the New York Stock Exchange provides:

"Every member organization is required through a general partner or an officer who is a holder of voting stock to

(1) Use due diligence to learn the essential facts relative to every customer, every order, every cash or margin account accepted or carried by such organization and every person holding power of attorney over any account accepted or carried by such organization.

(2) Supervise diligently all accounts handled by registered representatives of the organization.

(3) Specially approve the opening of an account prior to or promptly after the completion of any transaction for the account of or with a customer, provided, however, that in the case of branch offices, the opening of an account for a customer may be approved by the manager of such branch office but the action of such branch office manager shall within a reasonable time be approved by a general partner or an officer who is a holder of voting stock in the organization. The member, general partner or officer approving the opening of the account shall, prior to giving his approval, be personally informed as to the essential facts relative to the customer and to the nature of the proposed account and shall indicate his approval in writing on a document which is a part of the permanent records of his office or organization."

appear to serve two functions: protection of Exchange members and protection of the investing public. The former serves a "housekeeping" function for the Exchange, while the latter affects directly the interest of the public. Exchange rules which serve a mere "housekeeping" function are not, in the opinion of the Court, actionable; Exchange rules which affect the public interest, however, are actionable. In the opinion of the Court, a violation of Rule 405 is not actionable *per se,* since that rule appears to be one which, in part, is for the protection of Exchange members and to that extent may be characterized as a "housekeeping" rule. However, Rule 405 also, undoubtedly, has as one of its functions, the protection of the investing public and, to that extent, is actionable. Depending on the proof of the violation, therefore, Rule 405 could give rise to a civil action for damages under Section 6 of the Securities Exchange Act of 1934. Here the pleadings, depositions and affidavits on file indicate an almost callous disregard of Rule 405 and the purposes thereof which are directed toward protection of the public. Under the facts alleged in Count I of plaintiff's complaint and conditionally admitted by the defendant, the Court is of the opinion that the violation of Rule 405 alleged in this case constitutes a cause of action, which, if proven, would permit recovery.

3. Plaintiff's Second Cause of Action (Count II of the Complaint) involves an alleged violation of Section 17 of the Securities Act of 1933[2] and Rule 10(b)-5 promulgated

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2. Section 17 of the Securities Act of 1933 provides, in pertinent part:

> "(a) It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—
>
> (1) to employ any device, scheme or artifice to defraud, or
>
> * * * * * *
>
> (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser."

by the Securities and Exchange Commission under Section 10 of the Securities Exchange of 1934.[3] Under the facts alleged in Count II of plaintiff's complaint and conditionally admitted by the defendant, the Court is of the opinion that there is alleged an actionable violation of said Section 17 and said Rule 10(b)-5 in this case, which, if proven, would permit recovery.

4. Plaintiff's Third Cause of Action (Count III of the Complaint) involves alleged aiding, abetting and assisting in violation of said Section 17 of the Securities Act of 1933 and Rule 10(b)-5 promulgated by the Securities and Exchange Commission under Section 10 of the Securities Exchange Act of 1934. Under the facts alleged in Count III of plaintiff's complaint and conditionally admitted by the defendant, the Court is of the opinion that there is alleged an actionable aiding, abetting and assisting of a violation of said Section 17 and said Rule 10(b)-5 in this case, which, if proven, would permit recovery.

5. The plaintiff's Fifth Cause of Action (Count V of the Complaint) relies solely on Burns Indiana Statutes, Section 25-866. This statute creates no civil liability. There is no genuine issue of material fact with respect to plaintiff's Fifth Cause of Action (Count V of the Complaint), and the defendant is entitled to summary judgment as a matter of law with respect thereto.

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3. Rule 10(b)-5 of the Securities and Exchange Commission provides, in pertinent part:

> "It shall be unlawful for any person, directly or indirectly by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,
>
> (a) to employ any device, scheme, or artifice to defraud,
>
> * * * * * *
>
> (c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security."

Accordingly, the Court now Sustains said Motion for Summary Judgment as to the plaintiff's Fifth Cause of Action (Count V of the Complaint) and Overrules said Motion for Summary Judgment as to the plaintiff's First, Second, and Third Causes of Action (Counts I, II, and III of the Complaint). The Clerk is directed to enter an appropriate judgment in favor of the defendant on Count V of the Complaint.

WILLIAM E. STECKLER,
Judge, United States District Court.

UNITED STATES DISTRICT COURT.
* * (Caption—IP 66-C-210) * *

ENTRY FOR JUNE 24, 1968.

The Court having heretofore on April 25, 1968, entered an order on the motion of the defendant Merrill Lynch, Pierce, Fenner & Smith, Inc., for reconsideration of the ruling denying defendant's motion for summary judgment with respect to the causes of action appearing in Counts I, II and III of plaintiff's complaint which ruling was made June 28, 1967, by the Honorable William E. Steckler, Chief Judge for the United States District Court for the Southern District of Indiana, which order affirmed said prior ruling of the Honorable William E. Steckler, and having been requested by the defendant to consider the inclusion in said order of a statement in writing that it involves a controlling question of law as to which there is substantial ground for difference of opinion and that an immediate appeal therefrom may materially advance the ultimate termination of the litigation, in order that defendant may apply to the Court of Appeals for the Seventh Circuit for leave to appeal therefrom as provided by 28 U. S. C. § 1292(b), and having taken said request under advisement,

and being duly advised in the premises, now finds as follows:

1. The Court is of the opinion that the order of June 28, 1967 overruling defendant's motion for summary judgment with respect to the causes of action appearing in Counts I, II and III of plaintiff's complaint involves a controlling question of law as to which there is substantial ground for difference of opinion, and that an immediate appeal from said order may materially advance the ultimate termination of the litigation.

2. The order entered April 25, 1968 on defendant's motion for reconsideration should be modified and amended by adding thereto the following:

> Said order of June 28, 1967 should be modified and amended by including therein a statement in writing that this Court is of the opinion that such order involves a controlling question of law as to which there is substantial ground for difference of opinion and that an immediate appeal from said order may materially advance the ultimate termination of the litigation.

Accordingly, it is ordered, adjudged and decreed that said order of April 25, 1968 and said order of June 28, 1967, be and they are hereby respectively modified and amended in accordance with the above findings.

Dated this 24th day of June, 1968.

JAMES E. NOLAND,

Judge.

(R. 64-68, 162-164; Cert. App. 73-77, 99, 100.)

APPENDIX III.

This matter comes before the Court on the petition of defendant for leave to appeal under Title 28 U. S. C., Section 1292(b) from the order of the United States District Court for the Southern District of Indiana, Indianapolis Division, entered thereon on June 28, 1967, amended by the order of April 25, 1968; without opposition by the plaintiff.

It appearing to the Court that the said interlocutory order involves a controlling and important question of law in these proceedings and the District Judge has stated in an order that he is of the opinion that said order involves a controlling question of law as to which there is a substantial ground for difference of opinion, and that an immediate appeal from such order may materially advance the ultimate termination of the litigation;

It is hereby ordered that the petition of defendant is hereby granted and the leave to appeal from such interlocutory order of June 28, 1967, as amended by the order of April 25, 1968, is hereby allowed.

It is further ordered that bond for costs be provided in accordance with Rule 7 of the Rules of Appellate Procedure.

It is further ordered that a certified copy of this order be transmitted forthwith by the Clerk of this Court to the Clerk of the Southern Dis-

trict Court for the Southern District of Indiana, Indianapolis Division.

7/23/68 Defendant files cash appeal bond in the amount of $250.00 Said $250.00 deposited into the Registry of the Court as surety thereon. Court approves same. (R. 6, Cert. App. 6.)

APPENDIX IV.

STATUTES, RULES AND REGULATIONS INVOLVED.

Title 11 U. S. C. § 96(c)(2) and (5):

"(2) All property at any time received, acquired, or held by a stockbroker from or for the account of customers, except cash customers who are able to identify specifically their property in the manner prescribed in paragraph (4) of this subdivision and the proceeds of all customers' property rightfully transferred or unlawfully converted by the stockbroker, shall constitute a single and separate fund; and all customers except such cash customers shall constitute a single and separate class of creditors, entitled to share ratably in such fund on the basis of their respective net equities as of the date of bankruptcy; *Provided, however,* That such fund shall to the extent approved by the court be subject to the priority of payment of the costs and expenses enumerated in clauses (1) and (2) of subdivision (a) of section 104 of this title. If such fund shall not be sufficient to pay in full the claims of such class of creditors, such creditors shall be entitled, to the extent only of their respective unpaid balances, to share in the general estate with the general creditors."

"(5) Where such single and separate fund is not sufficient to pay in full the claims of such single and separate class of creditors, a transfer by a stockbroker of any property which, except for such transfer, would have been a part of such fund may be recovered by the trustee for the benefit of such fund, if such transfer is voidable or void under the provisions of this title. For the purpose of such recovery, the prop-

erty so transferred shall be deemed to have been the property of the stockbroker and, if such transfer was made to a customer or for his benefit, such customer shall be deemed to have been a creditor, the laws of any State to the contrary notwithstanding. * * *."

Title 11 U. S. C. § 110(a):

"(a) The trustee of the estate of a bankrupt and his successor of successors, if any, upon his or their appointment and qualification, shall in turn be vested by operation of law with the title of the bankrupt as of the date of the filing of the petition initiating a proceeding under this title, except insofar as it is to property which is held to be exempt, to all of the following kinds of property wherever located (1) documents relating to his property; (2) interests in patents, patent rights, copyrights, and trade-marks, and in applications therefor: * * * (3) powers which he might have exercised for his own benefit, but not those which he might have exercised solely for some other person; (4) property transferred by him in fraud of his creditors; (5) property, including rights of action, which prior to the filing of the petition he could by any means have transferred or which might have been levied upon and sold under judicial process against him, or otherwise seized, impounded, or sequestered: * * * (6) rights of action arising upon contracts, or usury, or the unlawful taking or detention of or injury to his property * * *."

Title 11 U. S. C. § 110(c):

"(c) * * * The trustee, as to all property, whether or not coming into possession or control of the court, upon which a creditor of the bankrupt could have obtained a lien by legal or equitable proceedings at the date of bankruptcy, shall be deemed vested as of such date, with all the rights, remedies, and powers of a creditor then holding a lien thereon by such proceedings, whether or not such a creditor actually exists."

Title 11 U. S. C. § 110(e)(1) and (2):

"(e)(1) A transfer made or suffered or obligation incurred by a debtor adjudged a bankrupt under this title which, under any Federal or State law applicable thereto, is fraudulent as against or voidable for any other reason by any creditor of the debtor, having a claim provable under this title, shall be null and void as against the trustee of such debtor.

"(2) All property of the debtor affected by any such transfer shall be and remain a part of his assets and estate, discharged and released from such transfer and shall pass to, and every such transfer or obligation shall be avoided by, the trustee for the benefit of the estate: * * * The trustee shall reclaim and recover such property or collect its value from and avoid such transfer or obligation against whoever may hold or have received it except a person as to whom the transfer or obligation specified in paragraph (1) of this subdivision is valid under applicable Federal or State laws."

Sections 70(a) and 70(e), July 1, 1898, c. 541, 30 Stat. 565 (U. S. Comp. St. § 9654):

"Sec. 70. (a) The trustee of the estate of a bankrupt, upon his appointment and qualification, and his successor or successors, * * * shall in term be vested by operation of law with the title of the bankrupt, as of the date he was adjudged a bankrupt, except in so far as it is to property which is exempt, to all (1) documents relating to his property; (2) interests in patents, patent rights, copyrights, and trade-marks; (3) powers which he might have exercised for his own benefit, but not those which he might have exercised for some other person; (4) property transferred by him in fraud of his creditors; (5) property which prior to the filing of the petition he could by any means have transferred or which might have been levied upon and sold under judicial process against him; * * * and (6) rights of action arising upon contracts or from the unlawful taking or detention of, or injury to, his property. * * *

"(e) The trustee may avoid any transfer by the bankrupt of his property which any creditor of such bankrupt might have avoided and may recover the property so transferred, or its value, from the person to whom it was transferred, unless he was a bona fide holder for value prior to the date of the adjudication. Such property may be recovered or its value collected from whoever may have received it, except a bona fide holder for value. * * *."

Title 15 U. S. C. § 77(q)(a):

"(a) It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—

"(1) to employ any device, scheme, or artifice to defraud, or

"(2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

"(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser."

Title 15 U. S. C. § 78f (a) to (d):

"(a) Any exchange may be registered with the Commission as a national securities exchange under the terms and conditions hereinafter provided in this section, by filing a registration statement in such form as the Commission may prescribe, containing the agreements, setting forth the information, and accompanied by the documents, below specified:

"(1) An agreement (which shall not be construed as a waiver of any constitutional right or any right to contest the validity of any rule or regulation) to comply, and to enforce so far as is within its powers

compliance by its members, with the provisions of this chapter, and any amendment thereto and any rule or regulation made or to be made thereunder;

"(2) Such data as to its organization, rules or procedure, and membership, and such other information as the Commission may by rules and regulations require as being necessary or appropriate in the public interest or for the protection of investors;

"(3) Copies of its constitution, articles of incorporation with all amendments thereto, and of its existing bylaws or rules or instruments corresponding thereto, whatever the name, which are hereinafter collectively referred to as the 'rules of the exchange'; and

"(4) An agreement to furnish to the Commission copies of any amendments to the rules of the exchange forthwith upon their adoption.

"(b) No registration shall be granted or remain in force unless the rules of the exchange include provision for the expulsion, suspension, or disciplining of a member for conduct or proceeding inconsistent with just and equitable principles of trade, and declare that the willful violation of any provisions of this chapter or any rule or regulation thereunder shall be considered conduct or proceeding inconsistent with just and equitable principles of trade.

"(c) Nothing in this chapter shall be construed to prevent any exchange from adopting and enforcing any rule not inconsistent with this chapter and the rules and regulations thereunder and the applicable laws of the State in which it is located.

"(d) If it appears to the Commission that the exchange applying for registration is so organized as to be able to comply with the provisions of this chapter and the rules and regulations thereunder and that the rules of the exchange are just and adequate to insure fair dealing and to protect investors, the Commission shall cause such exchange to be registered as a national securities exchange."

Title 15 U. S. C. § 78j (b):

"It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

"(a) . . .

"(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

Title 15 U. S. C. § 78s (b):

"(b) The Commission is further authorized, if after making appropriate request in writing to a national securities exchange that such exchange effect on its own behalf specified changes in its rules and practices, and after appropriate notice and opportunity for hearing, the Commission determines that such exchange has not made the changes so requested, and that such changes are necessary or appropriate for the protection of investors or to insure fair dealing in securities traded in upon such exchange or to insure fair administration of such exchange, by rules or regulations or by order to alter or supplement the rules of such exchange (insofar as necessary or appropriate to effect such changes) in respect of such matters as (1) safeguards in respect of the financial responsibility of members and adequate provision against the evasion of financial responsibility through the use of corporate forms or special partnerships; (2) the limitation or prohibition of the registration or trading in any security within a specified period after the issuance or primary distribution thereof; (3) the listing or striking from listing of any security; (4) hours of trading; (5) the manner, method, and place of soliciting business; (6) fictitious or numbered ac-

counts; (7) the time and method of making settlements, payments, and deliveries and of closing accounts; (8) the reporting of transactions on the exchange and upon tickers maintained by or with the consent of the exchanges, including the method of reporting short sales, stopped sales, sales of securities of issuers in default, bankruptcy or receivership, and sales involving other special circumstances; (9) the fixing of reasonable rates of commission, interest, listing, and other charges; (10) minimum units of trading; (11) odd-lot purchases and sales; (12) minimum deposits on margin accounts; and (13) similar matters."

Title 15 U. S. C. § 78aa:

"The district courts of the United States, and the United States courts of any Territory or other place subject to the jurisdiction of the United States shall have exclusive jurisdiction of violations of this chapter or the rules and regulations thereunder, and of all suits in equity and actions at law brought to enforce any liability or duty created by this chapter or the rules and regulations thereunder." * * *

Rule 10b(5) of the Securities Exchange Commission (C. F. A. § 240.10b-5):

"It shall be unlawful for any person directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,

"(a) to employ any device, scheme, or artifice to defraud,

* * * * *

"(c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security."

Rule 405 of the New York Stock Exchange:

"Every member organization is required through a general partner or an officer who is a holder of voting stock to

(1) Use due diligence to learn the essential facts relative to every customer, every order, every cash or margin account accepted or carried by such organization and every person holding power of attorney over any account accepted or carried by such organization.

(2) Supervise diligently all accounts handled by registered representatives of the organization.

(3) Specifically approve the opening of an account prior to or promptly after the completion of any transaction for the account of or with a customer, provided, however, that in the case of branch offices, the opening of an account for a customer may be approved by the manager of such branch office but the action of such branch office manager shall within a reasonable time be approved by a general partner or an officer who is a holder of voting stock in the organization. The member, general partner or officer approving the opening of the account shall, prior to giving his approval, be personally informed as to the essential facts relative to the customer and to the nature of the proposed account and shall indicate his approval in writing on a document which is a part of the permanent records of his office or organization."

. . . Supplementary Material:

.10 Application of Rule 405(1) and (3) [¶ 2405].—In the case of a margin account carried by a member organization for a non-member corporation, definite knowledge should be had to the effect that the non-member corporation has the right under its charter and by-laws to engage in margin transactions for its own account and that the persons from whom orders and instructions are accepted have been duly authorized by the corporation to act on its behalf. It is advisable in each such case for the carrying organization to have in its possession a copy of the corporate Charter,

By-laws and authorizations. Where it is not possible to obtain such documents, a member or allied member in the member organization carrying the account should prepare and sign a memorandum for its files indicating the basis upon which he believes that the corporation may properly engage in margin transactions and that the persons acting for the corporation have been duly authorized to do so.

In the case of a cash account carried for a non-member corporation, the carrying member organization should assure itself through a general partner or an officer who is a holder of voting stock that persons entering orders and issuing instructions with respect to the account do so upon the proper authority.

When an agency account is carried by a member organization its files should contain the name of the principal for whom the agent is acting and written evidence of the agent's authority.

When Estate and Trustee accounts are involved or when a husband is acting as agent for his wife, a member organization should obtain counsel's advice as to the documents which should be obtained.

In the case of accounts which are introduced by one member or member organization to another and are carried on a disclosed basis, the introducer will not be held to any responsibility under Rule 405(1) and (3) [¶ 2405] when the essential facts concerning a particular customer are obtained directly by the clearing organization and the opening of the account is approved by a member or allied member in the clearing organization "prior to or promptly after the completion of any brokerage transaction" and that is the understanding between the two.

As an alternative method of handling the investigation and approval of such accounts the clearing organization may treat the introducing organization, for the purposes of Rule 405(1) and (3) [¶ 2405], as though it were its branch office. Under these circumstances, the introducer will learn the essential facts with respect to each customer, and a general partner or an officer who is a holder of voting stock in the

introducing organization will give an approval for the opening of the account. The information obtained must subsequently be passed upon by a member or allied member in the clearing organization and any further inquiry which the clearing organization might feel is desirable should be made. However, the mere fact that the account is being introduced by another member, or member organization is not sufficient information to permit a member or allied member in the carrying organization to approve the opening of the account.

Information as to the country of which the customer is a citizen is deemed to be an essential fact. (2 CCH, N. Y. S. E. Guide ¶ 2405.)